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Before the
FEDERAL COMMUNICATIONS COMMISSION
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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)

Implementation of Sections of)
the Cable Television Consumer)
Protection and Competition Act)
of 1992)

MM Docket No. 93-215

Rate Regulation)

COMMENTS OF THE AERIE GROUP INCORPORATED

The Aerie Group is a consulting firm that advises state regulatory commissions, public advocates, and competitive service providers in telecommunications rate and policy proceedings. These comments propose revisions to the scheme for regulating cable television that would:

- (1) fulfill Congress's and consumers' expectation of lower cable rates by establishing a 22 percent benchmark for the reduction of basic tier prices,
- (2) promote competition not only in the provision of video entertainment but also for residential ISDN and other telecommunications services,
- (3) encourage responsible state and local regulation by delegating authority to make policy determinations consistent with the objectives of the Cable Television Consumer Protection and Competition Act ("1992 Cable Act").


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I. THE COMMISSION NEEDS MORE FULLY TO CONSIDER HOW ITS REGULATORY SCHEME FURTHERS THE BASIC GOALS OF THE 1992 CABLE ACT.

It is impossible to deny the technical virtuosity that underlies the report released on May 3, 1993 (MM Docket 92-266) ("May 1992 Order") and the notice of proposed rulemaking released on July 16, 1993 (MM Docket No. 93-215) ("NPRM"). These decisions set forth the options for regulation with considerable skill, ultimately proposing a mixed system of benchmarked ceilings that can be exceeded upon a cost-of-service showing made at the provider's option. However, there are inconsistencies and risks that this proposed scheme will be unable to realize the fundamental objectives and expectations that led to enactment of the 1992 Cable Act.

- Testimony before the House Telecommunications Subcommittee had indicated that rates in overbuilt communities were 20 percent lower than its communities with a monopoly franchise and that full competition could eventually lower cable rates by 50 percent. Hearings on H.R. 1303 and H.R. 2546 at 710 (July 26, 1991). The benchmark achieves only a 10 percent reduction in the national average.
- The Commission has yet to decide how to adjust the benchmarks to ensure that they continue to lower rates as competition intensifies. The rules fail to address the possibility of increased cross-subsidization and of potential manipulation of the sample by multiple system operators ("MSOs") who operate in both overbuilt and monopoly franchises.

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- Despite great uncertainty regarding the pace of competition, the Commission has not explained how cost-of-service regulation will respond to unanticipated changes in market structure and technology. Ironically, the cable industry may be entering a relatively severe form of cost-of-service ratemaking at the same time its potential competitor, the wireline telephone industry, obtains substantial deregulation.
 - Even though an absence of resources constrains the Commission's ability to implement effective regulation (and many of its policy judgments reflect ambivalence and uncertainty), the rules discourage state and local regulation by failing clearly to delegate authority to determine accounting principles and rate designs.

There can be little doubt that the initial re-regulation of the cable industry needs to reflect historical differences between cable and the telephone industry. The cable industry has a higher cost of capital, less scope to reduce personnel expense, and more companies that face high business risk, much of which results from overpriced acquisitions. At the same time, the regulatory framework for the cable and telephone industries should converge (and recede) as these companies confront competition from each other in an increasing range of services -- including video entertainment, residential ISDN, and basic telephony. Any imbalance in long-term regulatory schemes could hobble competition in each of these markets.



II. RATES FOR THE BASIC TIER SHOULD FALL BY 22 PERCENT.

Congress's fundamental goal for rate regulation was "to protect subscribers of any cable system¹ that is not subject to effective competition from rates that exceed the rates that would be charges if such cable system were subject to effective competition." H. Conf. Rept. 102-862 at 62 (Sept. 12, 1992). The Commission's assessment of a 10 percent price differential between monopoly and "competitive" services has confounded legitimate expectations of consumers, who anticipated much more substantial reductions.

The result appears to rest on two statistical fallacies. The first is the failure to compensate for the elimination of the "in terrorem" effect that helped keep prices down during Congress's consideration of cable re-regulation. The prices charged by monopoly systems are measured from 1992, when the entire industry was actively resisting re-regulation. During this period, there was some self-restraint among monopoly franchises, who feared that price increases could trigger a more severe form of regulation. By guaranteeing the benchmark rate, the Commission removes any uncertainty about what monopoly franchises can get away with. As a result, low-cost systems below the benchmark can increase rates, changing the benchmark from a ceiling to a de facto floor. The monopoly average will move even higher as high-cost carriers seek further increases through cost-of-service. At the same time, truly competitive systems will be reducing their prices. Some MSOs may cross-subsidize competitive territories by increasing rates in

¹ Consistent with the usage of the House Conference Report, the term "system" refers herein to each individual franchise area. The use of the term by the Survey Database included MSOs and referred to company-wide data.

monopoly franchises. For each of these reasons, the gap between monopoly and competitive areas will grow, defeating the fundamental objective of the 1992 Cable Act.

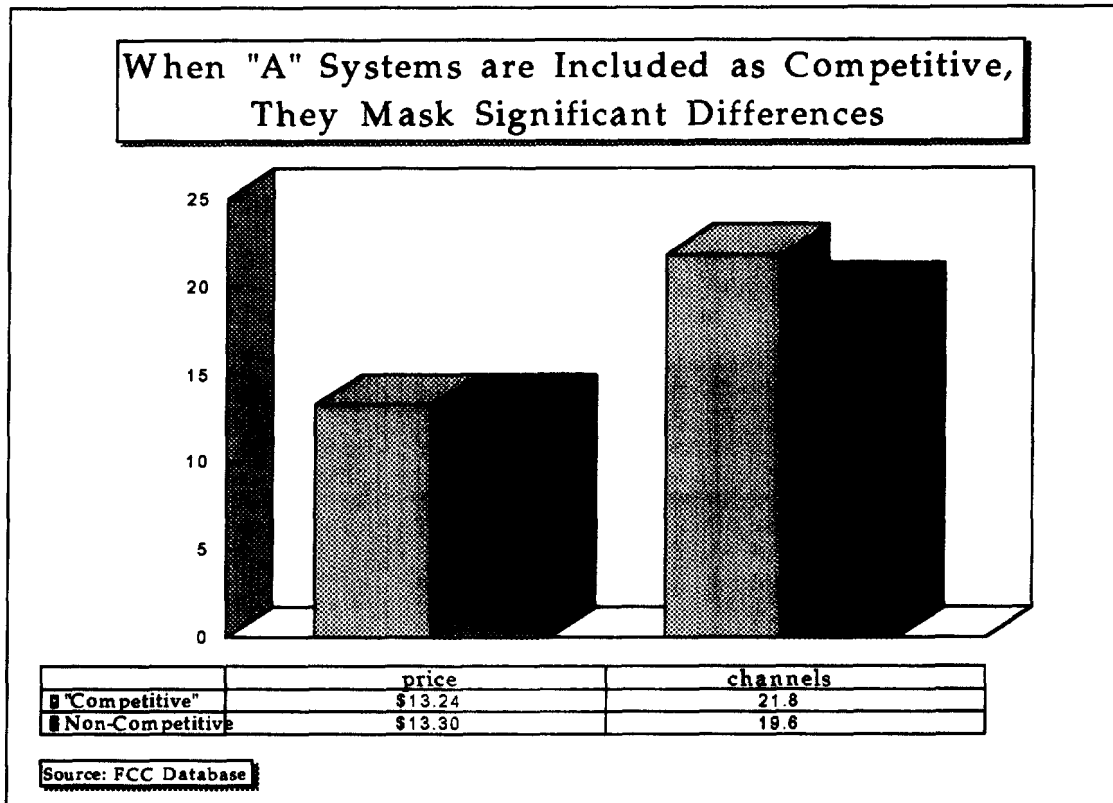
The second statistical fallacy results from the Commission's failure to distinguish between different types of "competition." Congress determined that a low-penetration system was "subject to effective competition" if fewer than 30 percent of the households in the franchise area subscribe." 47 U.S.C. §543(l)(1)(A). This so-called "type A competition" is substantially different from the forms described in subparagraphs (B) ("two unaffiliated multichannel video programming distributors each of which offers comparable video programming to at least 50 percent of the households") and (C) (a franchise authority that operates multichannel video programming to at least 50 percent of the households).

All three types of competitive systems are immune from state or federal regulation. 47 U.S.C. §543(a)(2). But there is no intention by Congress to promote low penetration. It is illogical to suggest that a system with 40 percent penetration could immunize itself from regulation by reducing its penetration (an objective that it could presumably achieve by increasing rates). Since low-penetration systems are not models, it is incongruous to treat them systems as comparable to truly competitive systems for purposes of establishing benchmarks. Nothing in the legislative history suggests such an illogical approach.

The Commission's regression analysis² fails to distinguish between low penetration and true competition. The database uses a single dummy

² It is impossible to replicate the regression described in the May 1992 Order (Appendix E at 12) because the explanation does not identify the independent variables that were tested in the stepwise regression procedure. The explanation acknowledges that

variable ("ABC") to identify systems that met any of the three tests. More detailed analysis shows that type A prices for the basic tier are 16 percent higher than the non-competitive areas. In part, this difference reflects

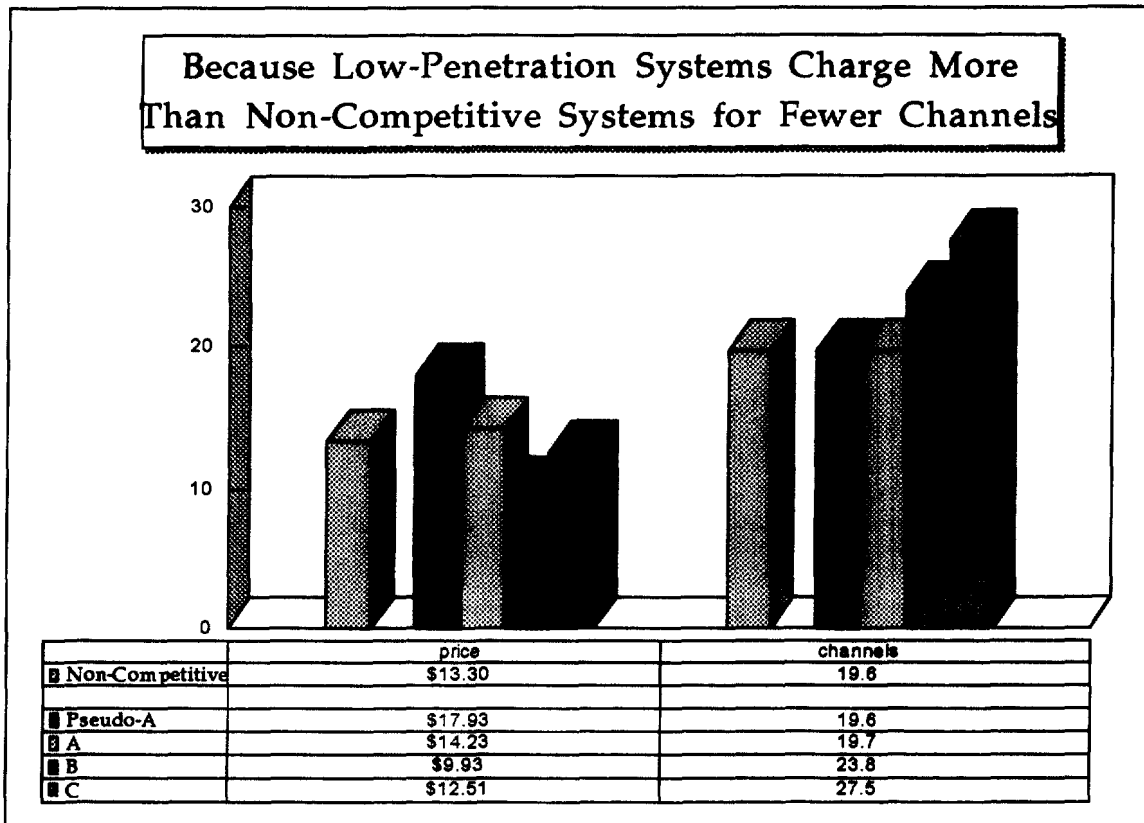


"pseudo-A" companies who claim low penetration only because they have expansive "franchise areas" in large parts of which they are neither required nor able to provide service. For example, West Virginia awards county-wide franchises to systems which do not attempt to serve the entire population.³ This loophole in the definition of "franchise area" must be closed. Of the "pseudo" type A companies where the percentage of passed-by households

"various formulations" for the dependent variable were used, but does not disclose the results or explain why natural logarithm of price per channel for up to three tiers was ultimately chosen.

³ D. Todd Carden, a member of the West Virginia Cable Television Board, suggested this analysis based on anecdotal experience with cable companies in West Virginia that are not included in the Commission's sample.

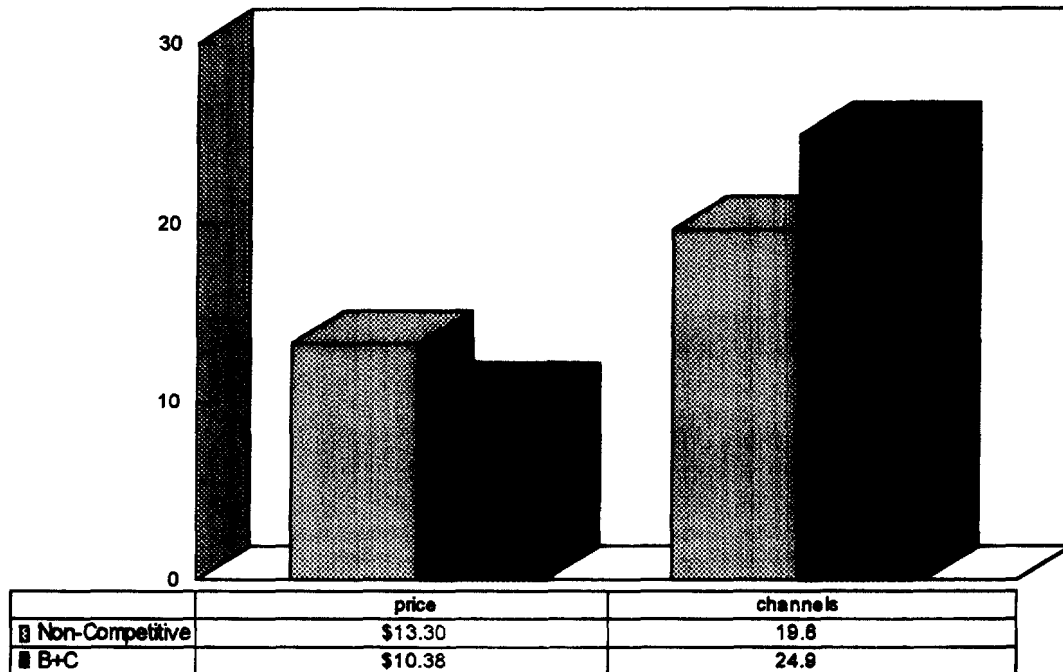
who subscribe exceeds 30 percent, the price for the basic service tier is actually 35 percent higher than the non-competitive systems.



When type A companies are eliminated from the sample, the expected relationship emerges. Competitive systems have basic tier prices that are 22 percent lower than their non-competitive peers -- and they offer 25 channels instead of 20. The Commission should recognize this relationship and require a rollback of 22 percent on the basic tier. To prevent evasion, there should be a prohibition on retiering in the absence of programming price increases.⁴ The operator should also be prevented from requiring basic subscribers to accept more channels for a higher total basic tier price.


⁴ A similar benchmark should be established for additional tiers based on the price differential between competitive and monopoly systems for the average subscriber bill (less the basic tier). In calculating the average bill, each tier would be weighted by the number of subscribers and the price. The percentage differential that results could then be applied across the board.

**Truly Competitive "B" and "C" Systems Charge
22 % Less for 27 % More Channels**



There are two additional concerns about the use of the database to establish benchmarks. First, the stepwise regression reportedly found that the impact of cost factors (e.g., subscribers per mile and percentage of plant underground) on price was not statistically significant. May 1992 Order, App. E, ¶ 27. This finding is not easily explained. It may reflect errors in data entry or deficiencies in the size and design of the sample. Alternatively, it may indicate MSOs and other operators price without regard to

The Commission has determined that establishing a different rate standard for the basic tier "could significantly increase the complexity of rate regulation." NPRM at 5 & n.7. But Congress repeatedly opted to "protect the interests of the consumers of basic cable service," "to keep the rates for basic cable service low," and to enable the Commission "to decide as a policy matter to keep the rates for basic cable service as low as possible. H. Conf. Rept. 102-862 at 63. Moreover, the proposed calculation is much simpler and more intuitive than the regression analysis put forward in the May 1992 Order.




cost. This is a characteristic of monopolies, but the statistical insignificance of cost factors also suggests that most systems are substantially above cost.

Second, the statute requires the Commission to report on average prices on a yearly basis. 47 U.S.C. §543(k). In future years, MSOs may have an incentive to maintain high prices in some competitive franchise areas in order to affect the reported price differentials. Of course, this will carry a penalty in the marketplace. For MSOs with only a small percentage of their operations subject to competition, this price may not be significant. Other MSOs may cross subsidize competitive operations, leading to a bias in the opposite direction. Accordingly, the Commission should code competitive systems that are affiliated with MSOs and consider stratified designs that increase the representation of unaffiliated competitive systems.

Finally, the Commission should plan for the development of competition at a rate that is even faster than most experts currently predict. The benchmarks need to be adjusted to ensure that the benefits of competition flow through to all consumers. Otherwise, ratepayers in rural and monopoly franchises may be exposed to price increases designed to cross-subsidize competitive responses by the entry telephone companies and wireless systems in urban areas.

III. TAKEN AS A WHOLE, THE SYSTEM OF REGULATION SHOULD MOVE TOWARD PLACING THE CABLE AND TELEPHONE INDUSTRIES ON A LEVEL COMPETITIVE PLAYING FIELD.


The Commission cannot reasonably expect that restrictions will long endure on the entry of telephone companies into video entertainment or on



cable companies participation in local telephony and access.⁵ This rivalry will lead to economic efficiencies, provided that protections are sufficient to prevent anticompetitive conduct. Of equal significance is the prospect that the cable and telephone industries will compete (possibly with wireless technologies) in markets for new services, such as distance learning and residential ISDN.

^ Any potential imbalance in the regulatory scheme will defeat the public interest because the cable industry may be the only credible potential rival to prevent a monopolization of critical new services, particularly in the residential market. In several jurisdictions, Bell Atlantic has proposed funding fiber optic networks at the expense of intrastate telephone rates, in order to provide "distance learning." In apparent contravention of this Commission's policies against subsidized terminal equipment, Bell Atlantic operating companies propose to provide "free" video equipment to schools. "C&P Customers To Help Pay for Fiber-Optic Network," Baltimore Sun, August 8, 1993, at 1A. The same fiber optic network will certainly be used when Bell Atlantic receives authority to offer video entertainment services within its service territory. Cable operators will have limited ability to respond to technologies, such as asynchronous circuitry, which provides video on demand, but only within a limited radius from the central office. 47 U.S.C. §543(d), added by the 1992 Cable Act, prevents cable operators from deaveraging rates in the face of a partial overbuild.


⁵ A federal district court recently declared unconstitutional those provisions of the 1984 Cable Act that prevented telephone companies from offering cable programming in their telephone service territory. One newspaper has reported that the government may not enforce the law pending an appeal. Cindy Skrzycki, "Ruling Opens Cable TV Rivalry," Washington Post, August 25, 1993, A1.



At present, the regulatory arrangements for cable cannot effectively mirror those for the telephone industry. Despite the congressional determination that the cable industry "has become highly concentrated," there are a larger number of providers with geographically small monopolies, many of which face substantial financial risks. Small and undercapitalized cable companies lack the "safety nets" enjoyed by rural telephone companies (except when they are the telephone company under the exception to the cross-ownership rules). The cost-of-service rules need to simplify reporting for small carriers. In the short term, there may be a limited need to consider special treatment of excess plant or acquisition cost for those unaffiliated small companies who can credibly show that they might otherwise face reorganization or insolvency. Any allowance of excess acquisition cost except in cases of genuine need could give rise to noneconomic reorganizations and divestitures, designed to achieve the best mix of alternative regulatory schemes for the shareholders of large MSOs.

For larger companies, the Commission should also reject the notion of "simplified cost-of-service showings" using standardized costs. See NPRM, ¶¶59-65, 74, fn78. The experience with large telephone companies on the "average schedule" for interstate access charges is very relevant. A blanket authorization of rates at levels sufficient to provide small carriers an opportunity to earn a reasonable return can result in substantial windfalls and duplicative recovery of costs for larger carriers with very different cost structures.⁶

⁶ Dr. Rafferty, principal of The Aerie Group, has filed testimony showing that the use of the average schedule by the Western Reserve Telephone Company, a mid-size carrier in Ohio, has contributed to a \$23 million revenue excess. PUCO Case 93-1525-TP-CSS. He has also advised the Pennsylvania Office of Consumer Advocate on excess earnings result-




In the short term, the purpose of the cost-of-service rules is to serve as a safety valve for companies who can credibly claim that the benchmarks are confiscatory based on company-specific factors. Where a company with profitable unregulated services (that make joint use of plant) seeks a rate increase in the first year of re-regulation, it should be required to submit to "total company" evaluation, in which the revenues from unregulated services offset any proposed rate hike. In this case, the benchmark form of regulation satisfies the constitutional protection against confiscation. "Total company" ratemaking also conforms to the congressional instruction not to permit the basic tier "to serve as the base that allows for marginal pricing of unregulated services." H. Conf. Rept. No. 102-862 at 63. Companies should be allowed to price non-cable services at the level of incremental cost in order to promote intermodal competition in new service markets. However, there needs to be a strict prohibition on pricing below incremental cost (to the extent that it is subsidized by raising local cable rates).

The Commission should also not allow accelerated depreciation on existing plant or valuation above original cost. To the extent a system resorts to cost-of-service regulation, its costs are above average. In the absence of new construction, it should not receive preferential treatment. Any allowance of accelerated depreciation expense should be targeted for new plant, which may improve the system's efficiency.

The Commission should adopt the rate regulation rules as transitional, with a view toward convergence with the system of telephone regulation. As the May 1992 Order (at ¶10) observed, "We anticipate that the regula-

ing from the use of "average schedule" by C-TEC, a cable holding company, for its affiliated local telephone operations in Pennsylvania.




tions we adopt today will change over time." The optimal structure of the rules may depend not only on experience with the regulatory framework, but on marketplace parameters that cannot accurately be predicted. If benchmark rates are stable, for example, the Commission should look askance at a company which moves from the benchmarks to cost-of-service. It may be appropriate to conduct a retrospective examination of depreciation, affiliate transactions, and other accounts that could be used to shift costs intertemporally. On the other hand, if competition expands rapidly, the Commission should be more tolerant of systems that cannot keep pace with dramatic decreases in the benchmarks.

IV. THE COMMISSION SHOULD ENCOURAGE STATE REGULATION AND DELEGATE AUTHORITY TO SET ACCOUNTING REQUIREMENTS AND RATE DESIGN.

As the Commission has previously found, "Local franchising authorities are envisioned as the primary regulators under the Act's framework." May 1992 Order, ¶54. States may also choose to consolidate service and rate authority in a statewide body. This centralizes expertise and may reflect an attempt to separate ratemaking authority from the municipality with a franchise fee that may increase with higher rates. This Commission should not only defer to these decisions; it should affirmatively encourage state and local bodies to assume responsibility for ratemaking.

The benefits of state ratemaking go beyond the conservation of resources by this Commission. State commissions are closer to the facts of an individual system and inherently more capable of making judgments of financial exigency that provide the only basis to relax traditional accounting principles. By contrast, this Commission necessarily deals with policy




decisions whose potential consequences must be "averaged" across a broad range of disparate companies. State commissions can provide a company-specific review as needed.

Although state and local jurisdiction is limited to the basic tier, there are issues of rate design where the local commissioner can credibly claim to determine preferences that may vary from state to state. It would be appropriate, for example, to give state commissions authority to veto moving specific channels from the basic tier to a federally regulated tier, provided that they allowed the company to flow through any exogenous changes in programming cost. State and local regulators should also be able to prevent expansion of the basic tier that increases the entry price for cable.

Finally, state commissions increase the perception and reality of democratic accountability. Where states are willing to assume responsibility for rate regulation, they are closer to the consumer. The perception of increased accountability is particularly valuable given the extent to which the complexity and number of cable companies forces this Commission to rely on staff delegations. 47 C.F.R. §0.61(j)-(n).

To prevent inconsistent development of nationwide competition, state regulation must be consistent with the 1992 Cable Act and the rules adopted to implement it. However, state ratemaking authority should be real and not simply the ministerial application of policy judgments standardized and preconfigured in every relevant detail. In this respect, there is some potential ambiguity in the May 1992 Order and the NPRM. The rules adopted in May require that the franchising authority

will adopt and administer regulations with respect to the rates for the basic service tier that are consistent with the regulations prescribed by



the Commission for regulation of the basic service tier. 47 C.F.R. §76.910(b)(1) [emphasis supplied]

The regulations that states must follow, although not enumerated, clearly include §76.922-76.943. Many of these provisions (such as the authority to prescribe, refund and fine) are enabling rather than mandatory.

It is not essential to the uniformity of policies of the 1992 Cable Act that this Commission should standardize accounting rules. The "General Accounting Requirement" proposed for 47 C.F.R. §76.1100 by this NPRM is expressly limited "for the purposes of providing accounting and costing data to the Commission and for making cost showings before this Commission." Proposed section 76.1101, which specifies "Recoverable Costs" is even more expressly limited to "cable services regulated by this Commission," rather than those regulated by state and local authorities. Both sections leave state commissions the ability to require supplemental reporting or to impose substantive jurisdictional differences.

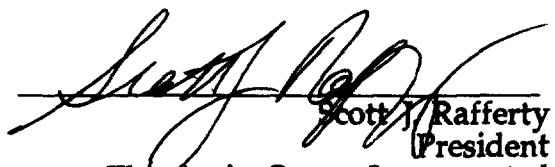
This Commission should defer to any reasonable determination of accounting rules, capital structure, or rate base and expense disallowances by state commissions. The state or local authority is more familiar with the specific circumstances and more accountable for any regulatory failure. On appellate review to this Commission, the cable operator will have a full opportunity to show any violation of due process or any substantial inconsistency with the rules for the basic tier.

CONCLUSION

In order to avoid unintended consequences, this system of cable rate regulation must retain flexibility and reflect a cooperative effort with state and local authorities. In the short term, it must achieve immediate

reductions of 22 percent at the basic tier in order to address the congressional requirement that the rates of noncompetitive systems be reduced to the level that would prevail under competition. The Commission needs to refine and revise its sample annually to ensure that the full benefits of increased competition inure to all ratepayers. In the long term, once true competition has arrived, the Commission must look to relaxing regulation and giving the cable industry a level playing field on which to contribute to the advancement of the nation's telecommunications infrastructure.

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